

THE CHALLENGES OF CHINA'S ECONOMIC REFORM: STATE
ENTERPRISE REFORM AND FINANCIAL LIBERALIZATION

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This thesis examines China's state-owned enterprise reform and financial reform in the last two decades. I characterize the progress of China's state-owned enterprises reform in two areas: privatization of small SOEs and mass layoffs. I argue that privatization rests on the political economy of China. I also discuss the evolution of the financial system and come up with some strategies of financial liberalization in China. Result from this study suggests that if the necessary reforms of the financial sector and state enterprises are effectively carried out, inevitably this will lead to a significantly slower rate of growth for a period of time. However, these reforms will provide the basis for a period of sustained growth in the long run.

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CHAPTER I

INTRODUCTION

After seventeen years of widely acclaimed economic reform, by 1996 China found itself still shackled by two vestiges of its pre-reform days: a large, inefficient state enterprise sector and an essentially unreformed financial system. The former continues to absorb and waste an enormous amount of the nation's resources, and the latter squanders the nation's precious savings in an arbitrary manner and generates recurrent bouts of rising inflationary pressures. Both are major hurdles on the nation's way towards market economy reform.

State-owned Enterprises Reform

Having experienced double-digit growth for nearly two decades, China's success in economic reform is widely known. Beginning with agrarian reform in the late 1970s and proceeding to market reform and openness in the 1980s, and especially the 1990s, China has made great strides in transforming its economy from the Maoist era. By 1993, growth of the non-state sector had transformed China's economy, without closing any state-owned enterprises (SOEs).¹ Between 1978 and 1993, the share of SOE employment was down from 75% to less than 60% in the urban areas and from 60% to about 30%

¹ In 1993, except for few joint ventures and joint-stock companies, firms in China had one of the three types of ownership: State-owned Enterprises (SOEs), Collective Enterprises (including Urban Collectives and Rural collectives; the latter are also known as Township-Village Enterprises, or TVEs), and Private Enterprises (including foreign firms). The latter two together are referred to as "non-state-ownership of firms" while the first two together are referred to as "public-ownership of firms".

with the inclusion of non-farm employment in the rural areas. During the same period, the state share of industrial output declined from 78% to 43% (China Statistical Yearbook, 1994).

Yet, many scholars qualify their evaluation of China's economic reform by pointing to the huge problem remaining for SOEs (Qian, 1996; Li, 1997; World Bank, 1997). By the early 1990s it had become evident that the lack of fundamental SOE reform had seriously undermined China's development. In 1994, China had about 300,000 SOEs (including 100,000 in industry) with about 75 million state employees (including 43 million in industry). These SOEs continue to consume a great portion of bank credit and other resources. Most have excess employment and close to half are loss makers.

In 1994, China began a quiet reform in privatizing and restructuring its SOEs under the slogan "grasping the large and letting go the small". The Fifteenth Congress of the Chinese Communist Party in September 1997 adopted a national policy to replace state ownership as the dominant ownership form of firms in the economy and to support privatization. This reform has proceeded in three areas: (1) privatization of small SOEs at the county level; (2) mass layoffs of SOE workers at the city level; and (3) mergers, groupings/conglomerations, corporatizations, and initial public offerings (IPO) of some large SOEs which often involve the central government. SOE reform has made significant progress in the first two areas: By the end of 1996, up to 70% of small SOEs had been privatized in pioneering provinces and about half were privatized in many other provinces. In addition, just between 1995 and 1997, for example, the total number of industrial SOE employees dropped by 3.6 million; over the same period, however, private-sector employment rose by 12 million and overall employment more than 16

million, despite the loss in SOE positions (Stiglitz, 1998). The third area of reform has not yet made any significant progress, which I will leave out in the thesis.

Financial System Reform

Modern economics has emphasized the importance of the financial system. It serves as the brain of the economy, ensuring that scarce capital is allocated to wherever it is most productive, and ensuring that funds are used in the way that the firm promised. Well-functioning financial markets enable risks to be transferred and diversified, so that firms can undertake riskier, and often higher-return, projects without fear of costly and disruptive bankruptcy. But modern economics has also emphasized that weaknesses in financial markets are a major source of vulnerability: financial crises have been frequent, perhaps even more frequent during the past twenty years than earlier. And when they occur, financial crises impose huge budgetary costs on the government, with major recent crises costing anywhere from 3 percent of GDP (in the United States) to 55 percent (in Argentina) to clean up. Even more important, financial crises have large adverse effects on the economy. Evidence from the past two decades shows that economies that experience a financial crisis see a sharp drop (1 to 1.5 percent) in GDP growth rates during the five years after the crisis; non-crisis countries show no drop at all (Stiglitz, 1998).

The development of the financial sector in China has lagged far behind that of other sectors of the economy. In China, the difficulties of restructuring banking and financial systems are even greater than elsewhere. For in socialist economies, so-

called financial institutions did not perform any of the functions that they do in modern market economies. Indeed, the name "bank" itself is misleading - and may mislead both policymakers and those inside the banks themselves. Under socialism, banks were not engaged in selecting and monitoring projects; production and investment decisions were made elsewhere; and the bank provided the finance only "under instruction." It provided a set of bookkeeping entries, a form of record-keeping, but banks were not key decision-makers. In modern market economies, they are the key decision-makers. Transforming banks from socialist to market institutions is thus not just a matter of changing ownership or control, but a watershed change in function and organizational culture(Stiglitz, 1998).

In the paper, first, I will describe the evolution of the China's financial system and present characteristics of China's financial system. Second, I will review the lessons of US financial market to China's financial reform. Then, I will come up with some strategies for the China's financial reform in the context of the political economy of China.

CHAPTER II

STATE-OWNED ENTERPRISES REFORM IN CHINA

Strategies of State-owned Enterprise Reform in China

This section discusses the strategies of state-owned Enterprises reform in China. First, I describe the significance of small and medium SOEs for China, and provide evidence on privatization of small SOEs at the county level. Because small and medium SOEs account for close to 60% of SOE employment, privatization of these SOEs is highly significant. I identify three features of this privatization. First, the liquidity and wealth constraints on the potential buyers of firms seem to be less a concern in China than in Eastern Europe or Russia. The reasons are China's high private savings rate and the net worth (and hence sale price) of most small and medium SOE is typically small due to its large debt-assets ratio. When the liquidity constraint is a concern, non-cash mortgage sales are used in some cases. Second, a large portion of privatized firms has taken the corporate form known as "stock cooperatives", which are essentially employee/manager ownership with some features of cooperatives. Third, new investments typically accompany privatization, which helps to produce profits and growth. I argue that two important political consequences of these three features of reform are that they reduce the resistance to privatization, and that they allow the great majority of the parties involved in privatization to realize benefits quickly, which increases the durability of reform.

Then, I discuss layoffs and reemployment in the process of enterprise reform. I present evidence on mass layoffs and reemployment from SOE to non-state firms at the

city level. This process is driven by the local government and has two inter-related components, known as *xiagang* (“stepping down from one’s post”) and *zajjiuye gongcheng* (“reemployment program”). Two interesting feature will be discussed. First, these components address both *ex ante* and *ex post* political issues concerning SOE reform. Under the former, laid-off workers are compensated *ex ante* in a credible way in the absence of social welfare institutions. Under the latter, the local government helps laid-off workers to find new jobs, which creates an *ex post* political environment in which workers, having new jobs, are less likely to oppose the reform and demand subsidies. Second, when the local governments are responsible for layoffs and reemployment, they can make best use of local information and pursue the reform at the speed and in the form according to local conditions.

Privatization of Small SOEs

The Status and Significance of Small SOEs in China

In China, there are two separate worlds in the state sector: one of small and medium SOEs under the supervision of local governments, and another of large SOEs under the central government. In contrast to Eastern Europe and the former Soviet Union, the distribution of SOEs by size in China is skewed toward the small enterprises; further they are spread throughout the country rather than geography concentration (Qian and Xu, 1993; Qian, 1996). Therefore, privatization of small SOEs is equally, if not more, significant in China than the reform of large ones.²

² Even in Eastern Europe, after several years of privatization, the most successful case seems to be also the privatization of small SOEs.

In a 1995 survey, the State Assets Management Administration reported that the state sector had about 300,000 SOEs. The top 1,000 SOEs accounted for 40% of total assets, 51% of net assets, and 66% of profits in the state sector (Qian, 1997). In 1993, although large industrial SOEs accounted for about 2/3 both in profits and taxes and in net value of fixed assets, small and medium industrial SOEs together accounted for 95% in number, 57% in employment, and 43% in output of the state industrial sector (Table 2.1).

Table 2.1 State-Owned Industrial Enterprises by Size (1993) (%)

	number	output	employment	net value of fixed assets	profits and taxes
Large	4.7	56.7	43.2	62.0	66.7
Medium	12.9	23.6	25.6	18.6	19.4
Small	82.3	19.7	31.1	19.5	13.9

Source: China Statistical Yearbook, 1994

Small and medium SOEs are mostly under the supervision of county and city governments (some are under that of provincial governments), and are often located in competitive industries, such as machinery, electronics, textiles, and food processing. The central government supervises most very large enterprises; some of them are in natural monopoly industries such as telecommunications and railroad transportation, and some are in government monopoly industries such as airlines, banks, electricity, oils, and petrochemicals. In terms of capital structure, small SOEs generally carry more debt than large and medium SOEs and they are highly leveraged by international standard.

In recent years, small SOEs also have generally had worse financial performance than large and medium SOEs. Most loss-making SOEs were small ones (Zhou and Shen,

1997): In 1994, 90% of the loss-making SOEs were small ones, while 82% of all SOEs were small ones. About 60% of small SOEs are making losses.³

Progress of Privatization

The process of SOE privatization at the county level began with pioneering counties. It became widespread between 1994 and 1996. There are no nationwide statistics for the extent of privatization.⁴ Surveys suggest that by the end of 1998, up to 70% of small SOEs had been privatized in pioneering provinces; most counties had moved from an experimentation stage to a promotional stage; and many provinces have completed change of ownership, in more than 50% of their small and medium SOEs at the county level (You and Wang, 1999).

Features of Privatization

I identify three features of privatization.

(1) Financing privatization

The liquidity and wealth constraints of potential buyers of firms were a major concern in the design of privatization programs in Eastern Europe and Russia and are partially responsible for the free distribution of shares. In China, these constraints are less of a problem. After more than fifteen years' reform, households have accumulated a huge

³ The average current loss is 2.2% as the share of total assets in small SOEs, as compared with 0.9% in large and medium SOEs; 6.7% as the share of net capital in small SOEs, as compared with 2.2% in large and medium SOEs. The profit-sales ratio is -0.78% for small SOEs, as compared with an average of 2.65% for SOEs overall; the profit-net asset ratio is -1.6%, with the average being 3.91%. Capital loss as a share of equity is 19.63% for small SOEs, and 8.88% for SOEs overall (Zhou and Shen, 1997).

⁴ It is useful to note that figures in various issues of *China Statistical Yearbook* do not reflect the true picture, because after privatization enterprises may take many different forms.

amount of private savings in the form of bank deposits.⁵ On the other side, most SOEs' debt-assets ratios are very high, even more so for small SOEs, and thus, typically, the net worth of these firms is small relative to total assets, sometimes even close to zero. Therefore, when such a firm is sold to employees or outside investors, the transfer price of equity is very low. In many cases, the employees can afford to purchase the enterprise with their own savings. In some cases, non-cash mortgage sales are used in privatization to relax the liquidity and wealth constraints of potential buyers when such constraints are a concern.

(2) Corporate governance and “stock cooperatives”

Although many varieties of corporate governance have emerged after privatization, three forms stand out: first, sales to a private domestic or foreign investor or firm; second, corporatization into a limited liability or joint stock company; and third, “stock cooperatives”, where shares are sold mostly to employees. In a survey from several provinces, these three forms account for more than half of all privatization. Stock cooperatives accounted for 35%; sales to private investors for 11%, and corporatization for 8%. The rest included bankruptcy, takeovers by other enterprises, and others (Liu, 1997). Apparently, stock cooperatives are the major corporate form after ownership reform.

Stock cooperatives are not one form, but incorporate many varieties.⁶ Typically, a

⁵ In 1993, household bank deposits and total financial assets were about 1 trillion Yuan and 2 trillion Yuan respectively, as compared to the total state assets of 3 trillion Yuan (China Statistical Yearbook, 1994).

⁶ Until mid-1997, there was still no nationwide regulation on stock cooperatives. As a result, these firms are not categorized together and shown in a statistical yearbook. Some of them are treated as limited liability companies, some as joint stock companies, and some are still listed as SOEs (Institute of Economic System Reform, 1997). In August 1997, the State Commission for Restructuring the Economic System issued the first nationwide “guiding suggestions,” for the urban stock cooperatives. This document suggests

stock cooperative can be viewed as a limited liability or joint-stock company in which enterprise employees (including managers) own a majority of the total shares of the firm; and transfers of these employee shares are restricted in some ways. There are cases in which firms issue shares to be “collectively” owned by employees, which means that these shares feature “one-person-one-vote.” But in most cases firms do not have “collective shares” having instead shares according to the standard principle of “one-share-one-vote.” Share distribution among employees may not be equal either, with managers typically having more shares (Institute of Economic System Reform, 1997).

Clearly, stock cooperatives are not conventional corporations as in the developed West. Nor are they traditional producer cooperatives: the number of shares differs for employees depending on subscription, and there may be important outside investors. Generally speaking, they are partial employee/manager ownership with some features of cooperatives. Because employees often buy shares at discount, I suspect that stock cooperatives are used to reduce the *ex ante* political resistance to privatization from workers. It is not clear whether stock cooperatives are a transitory or permanent corporate form. Initial reports suggest they are transitory. Already some stock cooperatives have been transformed into standard limited liability or joint-stock companies, often after managers bought controlling shares (Institute of Economic System Reform, 1997).

(3) Privatization together with new investment

Two phrases capture an important feature of privatization: transferring existing

that in stock cooperatives the number of employee/manager shares should be the majority of the total shares of the firm, and for the rest, the document’s guidelines are quite flexible (*Economic Daily*, August 7, 1997).

stocks from the state to private hands and expanding stocks with new private investment. The combination of privatization of the existing stocks together with adding new investment is highly significant, because in this way, privatization not only transfers asset ownership, it simultaneously adds new resources. As a result, some former SOEs quickly turn to making profits after privatization. China's high savings rate and the large amount of foreign direct investment have clearly contributed to this feature.

The change in enterprise ownership combines with the injection of new investment to suggest that privatization may soon bring benefits to most, if not all, major parties whose interests are at stake. Privatization is thus not only economically efficient; it also has significant political implications. Making most parties better off in a short period of time reduces the chance of reversal of the reform *ex post*. The central government, often as a minority shareholder, gets something back for its invested equity and, if the company grows, the value of its remaining equity appreciates. This growth-induced *ex post* political situation reduces the pressure to turn backwards after privatization.⁷

Layoffs and Reemployment

The Problem of Excess Employment in SOEs

Privatization mainly concerns assets and layoffs and reemployment concern people. As with most socialist SOEs, SOEs in China are overwhelmed with excess

⁷ According to some sources, most provinces see some growth of former SOEs soon after privatization; at the very least privatized firms stop making losses. A survey comparing 66 enterprises before and after privatization found that, on average, assets increased by 113%, profits and taxes by 100.600, tax revenue paid to the government by 96.3%, state equity value by 105%, and employee wages by 75% (You and Wang, 1997).

employment. This is particularly an acute problem for some old industrial centers developed on the Soviet model (such as Northeast region of China) and for some industries that lost competitiveness after the entry of non-state firms (such as textile and machinery). For these firms, privatization of assets is often not the main concern; rather, the main concern is reallocation of the labor force.

In recent years, many cities have started restructuring medium and large SOEs by laying off excess workers and helping them to find jobs in non-state firms. Two new terms emerged and became the most frequent phrases appearing in the press to describe this process: *xiagang* (or “stepping down from one’s post”) and *zajiuye gongcheng* (or “reemployment program”). They not only signal the extent of layoff and reemployment, but also indicate their important features.

Progress of *Xiagang* and Reemployment

According to the State Statistical Bureau, employees in the *xiagang* category are those “who went home from enterprises due to poor performance of enterprise but still maintained some nominal relationship with their enterprises” (Song, 1997). The nominal relationship exists because the former employees continue to receive a subsistence salary and/or other kinds of benefits (such as housing or health) from their old enterprises. Therefore, these *xiagang* workers are workers laid off from SOEs with some compensation and protection.⁸

Statistics on the number of *xiagang* workers are incomplete and vary by source

⁸ The number of *xiagang* workers is usually smaller than the true number of layoffs because it does not include those laid off under bankruptcy or those who had already completely severed their relationship with

(reported from the labor bureau, statistical bureau, or the enterprises themselves). An approximate picture can be formed. In one account, the director of the State Statistical Bureau reported in April 1997 that more than 10 million factory workers lost their jobs in 1996 (*China Daily*, April 5, 1997). According to a more detailed report made by the Department of Population and Employment of the State Statistical Bureau in May 1997, the total number of *xiagang* workers at the end of 1996 was about 8.9 million, of which 63% were from SOEs with the rest from urban collectives (Song, 1997). An additional 5.6 million workers were laid off in the first half of 1997 and a total of 13.7 million could be out of job by the end of 1997 (*China Daily Business Weekly*, November 2, 1997). This would imply that about 20 million *xiagang* workers, or roughly ten percent of the total urban labor force, were laid off by the end of 1997.

Together with *xiagang* is *zajiuye gongcheng*, that is, local government assisted reemployment program for laid-off SOE workers. The “reemployment program” became a major job for local governments. According to one report, by the third quarter of 1996, about 5 million laid-off workers had participated in “reemployment programs.” In these programs, about 3 million workers participated in new career instruction and 1.1 million received retraining. Of the 5 million, 4.5 million received unemployment benefits and 2 million received temporary relief. Finally, about 2.4 million were actually reemployed (Wang, 1997).

Features of Layoffs and Reemployment

the enterprises. The *xiagang* figures also do not include those workers in privatized SOEs.

(1) The *ex ante* and *ex post* political economy of *xiagang* and *zaijiuye gongcheng*

The combination of *xiagang* and *zaijiuye gongcheng* can be viewed as an attempt by local governments to address both the *ex ante* and *ex post* political issues surrounding reform. When the local government uses *xiagang* to lay off workers, workers receive credible compensation for a given period of time because they still maintain some relationship with the enterprises used to employ them. This is especially important given the absence of well-functioning social welfare institutions. Although such compensation addresses part of the *ex ante* political constraints of reform, it alone may not be enough to address the *ex post* political problems: laid-off workers may continue to demand subsidies when they do not have new jobs. When a local government helps laid-off workers find new jobs, it creates an *ex post* political environment in which workers, having new jobs, are less likely to oppose the reform and demand for subsidies.

(2) The use of local information and adaptation to local conditions

Because local governments have better knowledge about local conditions than the central government, when they are responsible for layoffs and reemployment, they can make best use of local information. For example, local governments can pursue the reform at the speed suitable to the local conditions. It is thus critical that the central government is not forcing local governments to reform all at once or all at one speed. Thus, if the local government finds that workers are not being absorbed as fast as predicted, it can slow down the pace of reform. This in part accounts for unevenness of reform progress across localities. Unevenness may thus become a political virtue when it implies an absence of large labor dislocations and the serious political disorder that accompanies privatization that occurs all at once.

The Political Economy of the State-owned Enterprise Reform in China

In this section, I will discuss the State-owned enterprise reform in the context of political economy in China. What are the economic and political foundations of SOE reform? What are the incentives of local governments to privatize and restructure the firms under their supervision? Economists often assume that privatization programs result from an exogenous political event, ignoring the issue of government incentives to initiate reform.

First, I will argue that China's particular framework provides two major sources of political incentives for local governments to undertake the reform. First, recent reforms in tax, fiscal, monetary, and banking have hardened the budget constraints of local governments. The hard budget constraint means that local governments — and the SOEs under their supervision — must float on their own financial bottom. In China, it is the hard budget constraint that prompts local governments to privatize. This reform path stands in contrast to SOE privatization in Eastern Europe and the former Soviet Union where reformers attempted to use privatization to harden budget constraints of enterprises. Second, increased competition from the non-state sector raises competitive pressures on SOEs. Because of the twenty years of successful reform, the non-state sector in China has already become a major force in the economy, for example, foreign firms and rural enterprises alone have accounted for more than one half of the national industrial output.

Then, I will argue that harder budget constraints, together with increased competition, have changed the costs and benefits to local governments for keeping SOEs. In recent years many SOE's performance deteriorated quickly amid increasing

competition from non-state firms. Under a hard budget constraint, increasingly poor SOE performance implies that these enterprises became increasingly heavy fiscal burdens for the local government budget. Financing these losses crowds out other expenditures, thus providing local governments with an incentive to privatize and restructure SOEs.

Hard Budget Constraints for Local Governments

The soft budget constraint is widely seen as one of the biggest problems for both governments and enterprises in all transition economies. Put simply, enterprises or governments which are endlessly bailed out have no incentive to make financially prudent decisions, let alone efficient ones. Hardening the budget constraint has been a major objective of the reform. In Eastern Europe and the former Soviet Union, reformers attempted to use privatization as a way to harden budget constraints of enterprises. In China, it is a different path: the hard budget constraint of local governments induces privatization of enterprises under their supervision.

Both fiscal and financial reforms between 1994 and 1996 in China have played important roles in hardening the budget constraints of local governments. These reforms effectively corrected some problems arising from the decentralization of the 1980s (Qian and Weingast, 1996). Yet, the fundamental feature of decentralization remains: local governments continue to assume primary responsibility for managing the local economies and have their own revenue sources.

In 1994, China introduced a major tax reform which (i) introduced a clear distinction between national and local taxes; (ii) established a national tax bureau and local tax bureaus each responsible for its own tax collection; and (iii) determined that

value added tax (VAT) would become the major indirect tax to be shared by the national and local governments at a fixed ratio of 60:40. Before this reform, China did not have a national tax bureau and all taxes were collected by local governments. Local governments often reduced or exempted taxes which were supposed to be paid to the central government. The tax reform has made it very difficult for local governments to reduce national taxes as in the past (Fan, 1998). The tax reform has established some fixed tax rules between the national and local governments. It also has led to some reduction of local government revenue shares in the official “budgetary” and “extra-budgetary” accounts (Table 3.2).

Table 2.2 Share of Local Government Revenue in Total Government Revenue

	1988	1989	1990	1991	1992	1993	1994	1995	1996
"budgetary"	0.67	0.69	0.66	0.7	0.72	0.78	0.44	0.48	0.5
"budgetary" and "extra-budgetary"	0.64	0.64	0.63	0.64	0.63	0.79	0.55	0.59	

Source: China Statistical Yearbook, 1996

In 1995, the new *Budget Law* took effect. It prohibited the central government from overdrawing the central bank and from deficit financing its current account. The central government was allowed to have deficit financing in the capital account but it had to be financed by government bonds. The requirements for local governments were more stringent. Local governments at all levels were required to have their budgets balanced, and, furthermore, the law strictly controlled bond issuance and restricted borrowing in the financial market by local governments. To ensure enforcement of the *Budget Law*, an independent auditing system was also introduced.

Increased Competition from the Non-State Sector

China is known for its rapid expansion of the non-state sector in the early stages of reform (Qian and Xu, 1993). By 1993, the state's share of industrial output in the national economy had declined to 43%. After Deng Xiaoping's southern tour in 1992, expansion of non-state-owned enterprises obtained a new momentum.

Both foreign firms and domestic non-state firms have become the major sources of the competition. The former are the result of the rapid increase of foreign direct investment (FDI) to China, and the latter are mostly from rural enterprises which include both Township-Village Enterprises (TVEs) and private enterprises. By the mid-1990s, foreign firms together with rural enterprises already accounted for more than half of China's industrial output. As a result, competition pressure on SOEs from non-state firms reached a new level. Furthermore, this competition affects more SOEs supervised by local governments than those by the central government because most of the former are in competitive industries where the non-state firms entered.

Other Considerations

In addition to the harder budget constraints for local governments and increased competition from the non-state sector, other factors may also affect the incentives of local governments for privatization. I discuss below the roles of the central government and SOE managers respectively.⁹ However, they may not be independent factors.

(1) The role of the central government

⁹ Another factor affecting SOE privatization and restructuring concerns the emergence of complementary social welfare institutions which were completely absent a few years ago. This may reduce the costs of

The process of privatization and restructuring in China has been mainly driven by local government. This does not mean that the hand of the central government is absent. After all, the central government retains ultimate ownership rights to all SOE assets. Changes in SOE property rights therefore require the central government's endorsement. The willingness of the central government to do so is driven by the local governments. To a large extent, the central government's ideological constraint has become relaxed because of the local initiatives. Relaxation of the ideological constraint in turn encourages local governments to push privatization even further because it reduces the costs of privatization due to political risks.

(2) Insider control of SOEs: the role of SOE managers

The SOE reform of the 1980s, attempting to expand enterprise autonomy under the "contract responsibility system", produced an important legacy for the 1990s. It created a tendency toward what is known as "insider control." That is, enterprise managers used their effective control over the assets of SOEs to benefit themselves at the expense of the state. In the extreme form, managers steal money and assets from enterprises. Indeed, the so-called "state asset stripping" problem has increased at an alarming rate in the past few years. The increased insider control of SOEs reduces profitability of SOEs even without increasing their inefficiency. This source of losses consequently reduces the benefits for local governments to maintain these SOEs.

Nonetheless, the increased agency problem of managers alone is not sufficient to provide the government with incentives for privatization for three reasons. First, the

privatization and layoffs. However, such social institutions remain very primitive in China. This makes *xiagang* an important form of compensation for laid-off workers.

government still has the option of taking back some of the managerial autonomy. The government may not want to do so exactly because it will fail to provide managerial incentives in the new market environment. Second, although the agency problem reduces the profitability of SOEs, without competition, the government still can enjoy considerable monopoly rents, as in many monopoly SOEs under the supervision of the central government. Third, without a hard budget constraint, governments may still have no incentives to privatize loss-making firms.

The Incentives of Local Governments: The Costs and Benefits of Privatization and Restructuring

The local government's decision about whether to privatize SOEs depends on their costs and benefits. Harder budget constraints of local governments and increased competition from the non-state sector made it increasingly costly to maintain these inefficient enterprises. Keeping inefficient SOEs deters creation of more employment, another important governmental objective. It also diverts the attention of local governments from being good regulators of their local economies, which are increasingly represented by non-state firms. Finally, with many inefficient enterprises, the same amount of money goes farther in privatization than in maintaining the old SOEs.

The deterioration of SOE financial performance in recent years, in particular at the local level, is astonishing. This makes privatization of these SOEs a more pressing issue. Between 1988 and 1996, the share of loss-making industrial SOEs nationwide increased from 12% to 38%, and in 1996, the amount of losses exceeded after-tax profits for the first time in history (Table 2.3). The financial burden of SOEs on the government

thus increased drastically.

Table 2.3 Loss-Making State-Owned Industrial Enterprises

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Share in number	0.12	0.16	0.32	0.30	0.25	0.30	0.33	0.34	0.38
Loss/After-Tax Profits	0.09	0.24	0.90	0.91	0.69	0.55	0.58	0.81	1.74

Source: China Statistical Yearbook, 1997

Loss-making SOEs are concentrated in small SOEs, which are mostly supervised by county governments: 90% of loss making SOEs are small SOEs, and 60% of all small SOEs are not profitable (Zhou and Shen, 1997). This is not surprising because SOEs under county government cannot compete with rural enterprises and foreign firms due to a lack of incentives. They cannot compete with large SOEs either because they lack the technology, human capital, scale economy, or monopoly power. These small SOEs are squeezed between non-state firms and large SOEs.

There are also opportunity costs for the local government in keeping inefficient SOEs. Traditionally, SOEs are the major source of government revenue and non-state enterprises only contributed a tiny fraction to the government budget. This is changing. In 1995, revenue contributed by non-state enterprises already accounted for more than 40% of the revenue from all industrial enterprises.

In summary, local governments' incentives for privatization and restructuring depend on the costs and benefits of the alternatives. Local governments can be an inducement for efficiency-enhancing privatization and restructuring when they are under hard budget constraints and facing market competition. Therefore, privatization, Chinese style, can be better understood in the framework of political economy in China.

CHAPTER III

FINANCIAL SYSTEM REFORM IN CHINA

Evolution of China's Financial System: An Overview

This section presents a brief, critical review of the principal features of China's financial system and conduct of monetary policy. It shows that despite its impressive growth since 1979, the financial system in essence still functions as it did before reform. With centrally allocated credits and administered interest rates, it lacks a mechanism to ensure efficiency in capital allocation. Moreover, a stop-go monetary policy combined with the inherent arbitrariness of the credit plan has produced frequent cycles of inflation alternating with growth recession.

Financial sector reform in China has focused on the reform and development of banking and non-banking¹⁰ financial institutions, though capital market development has lagged behind. Initial reform of the financial sector has been characterized by the establishment of the two-tier banking system, with the establishment of the central bank and specialized banks. But a major development occurred in the non-banking sector--the emergence of the non-banking financial institutions (NBFIs), including rural and urban credit cooperatives, and trust and investment corporations. Commercialization of state banks, opening the financial sector for foreign competition, and development of financial markets have only taken place to a limited degree.

Reforms in the financial sector can be divided into four phases (Mehran, 1996).

¹⁰ Non-banking financial institutions in China refers to financial institutions other than the banks, including the rural and urban credit cooperatives, trust and investment companies, and finance, insurance, and leasing companies.

The first phase, from 1978 to 1984, witnessed the re-establishment of the banking system in early years of reform. Limited reform was introduced during that period. The second phase of reform, from 1984 to 1988, was marked by the establishment of the central bank, the state specialized banks, and development of non-banking financial institutions. The third phase (1988-91) is a rectification period, and witnessed the interruption of the liberalization and government re-centralizing control of the financial sector. The fourth phase, from 1992 to the present, was a period of deepening financial reform, during which new non-state commercial banks were established, policy lending banks have been introduced to pave the way for the commercialization of state banks, and the legal framework of financial institutions was improved.

The Role of Banks and Banking Before Economic Reform

The financial system before reform was characterized by the all-inclusive mono-bank system established in 1950, based on the Soviet banking system. The Chinese financial system was originally designed to serve the planning process rather than to perform the functions of a traditional financial system. Prior to 1978, the Peoples Bank of China (PBC) served as both a central bank and commercial banks, controlling about 93 percent of the total financial assets of the country and handling most financial transactions in the economy (Yi, 1994). The function of the banking system was confined to facilitate the financing of the economic plan. The PBC acted mainly as cashier, with its functions confined to issue currency and credit, and carrying out the settlements of state-owned enterprises transactions.

The financial system before reform was a mono-bank system, which was the

agency of central planning authorities. The issuances of currency and credit were determined by the State Council and the Peoples Bank was not independent, rather it was only a government agency under the Ministry of Finance and its primary function was to finance the physical plan. The role of the financial system in mobilizing savings was very limited, because the primary source of savings was government and state-owned enterprises. The role of financial intermediation in resource allocation was also limited, because most investments were determined and financed by the government budget appropriations, rather than through the banking system. Except for the banking system, there were no non-bank financial institutions and financial markets, and bank deposits were the only financial assets.

Early Years of Reform: Structural Changes in the Banking System (1978-84)

In 1978, the People's Bank of China (PBC) was formally established as China's Central Bank, and separated from the Ministry of Finance. In addition, the specialized banks were set up to handle loans to specific sectors. The Bank of China (BOC) was restored to handle transactions related to foreign trade and investment, while the People's Construction Bank of China (PCBC) was set up primarily to serve the construction sector and fixed asset investment. The Agriculture Bank of China (ABC) was established to take over the PBC's rural banking business.

This period also witnessed the start of the development of non-banking financial institutions (NBFIs). Successful reform in the rural areas and the proliferation of rural industries dramatically increased the demand for financial services from rural residents. Thus, a network of rural credit cooperatives was set up under the supervision of the

Agriculture Bank of China (ABC) to provide small-scale rural banking services to rural residents and township and village enterprises. Concomitantly, another type of NBFI, namely the trust and investment corporations, began to appear. The first TIC, the China International Trust and Investment Corporation (CITIC), was established in 1979 to raise funds from foreign sources to finance domestic projects. CITIC has been the primary source for most international bond borrowing made by China during the 1980s.

This period also experienced important changes in the sources of both savings and investment. On the savings side, the decentralization of financial resources into the hands of households led to an explosion in savings deposits. On the investment side, bank loans replaced the state budget appropriations as the main source of investment finance. Following a directive of the State Council in 1979, the main source of investment funds was shifted gradually from state budget to bank loans. Both the PBC and the specialized banks were authorized to grant medium-term to long-term loans to state enterprises. As a result, the composition of funds allocated to state-owned industrial enterprises changed rapidly from budget appropriations in 1978 (70 percent) to state bank loans in 1982 (80 percent) (Mehran, 1996).

Despite the structural changes described above, the banking system still served the limited purpose of financing the physical plan. The People's Bank still assumed the functions of both a central bank and a commercial bank as it continued to provide working capital loans to state-owned enterprises. Loans were directed to state-owned enterprises under the credit plan, and neither the project's profitability nor the borrowers repayment ability was taken into consideration in granting loans. Furthermore, bank monitoring of state owned enterprises was almost non-existent.

Starting Financial Reform: Development of Banking and
Non-Banking Institutions (1984-88)

The second phase, from 1984 through 1988, was the real start of financial-sector reform, though this represented a significant lag with respect to reforms in other sectors of the economy. The most significant change was the establishment of a two-tier banking system similar to that in market economies. In 1983, the People's Bank of China was formally established as the country's central bank by removing its commercial banking activities. A fourth specialized bank, the Industrial and Commercial Bank of China (ICBC) was formed to take over the functions of financing industrial and commercial enterprises formerly assumed by the PBC. Thus, the transition from the mono-bank system to a two-tier banking system was completed and China became the first socialist country to have a full-fledged two-tier banking system, comprised of a central bank--the PBC, and four state-owned specialized banks--the ABC, the BOC, the ICBC, and the PCBC.

There were also significant changes in investment channels. Budgetary funds for investment in state-owned enterprises were further cut and replaced by bank lending, and SOEs were encouraged to borrow from state banks to finance projects instead of relying on state budgets as in the past. As a result, the government found it increasingly difficult to keep control of the mobilization of savings and investments.

The financial sector diversified further after 1984. Following the establishment of the Industrial and Commercial Bank, 1,200 urban credit cooperatives were set up. In addition, new non-state commercial banks were established, including the Bank of Communications (BOCOM) and China International Trust and Investment Corporation

(CITIC) Industrial Bank, a wholly owned subsidiary of the China International Trust and Investment Corporation (CTTIC). These two universal banks were permitted to compete with state specialized banks in all forms of business. Competition among the state specialized banks also increased during this period, as they were allowed to conduct business outside their specialized areas.

A major innovation during this period was the development of non-banking financial institutions--in particular the proliferation of trust and investment corporations (TICs). Starting in 1986, hundreds of TICs were set up by state specialized banks and provincial governments initially to circumvent credit quotas or finance local investment, but many of them had been increasingly involved in commercial banking business, taking household deposits and granting working capital loans to provincial and local industries. As a result, the proliferation of TICs increased competition in the financial sector, but it also led to the over-extension of credit and resulted in rising inflation.

Financial Stabilization and Development of Capital Markets (1988-91)

The pace of financial sector reform slowed down during 1988-91 because of the stabilization program to control inflation. The government increased administrative control over the economy and considerable centralization took place. The role of government-directed credit regained significance. Government also increased control on the non-bank sector, the main source of inflation. The TICs went through reorganization and the PBC increased supervision and control over their lending. Many TICs were merged and closed and the number of TICs was significantly reduced.

Despite these stabilization measures, the financial sector introduced limited reform,

including the establishment of financial markets. The Shanghai Stock Exchange was officially opened at the end of 1990, and the Shenzhen Stock Exchange 'vas significantly reorganized in 1991.

Deepening Financial Reform (1992-present)

The year 1992 marked the new era of economic reform, with the famous “southern tour’ of Deng Xiaoping. The economy started to boom and the flow of foreign direct investment to China increased substantially. The period also witnessed an expansion of the banking sector and the deepening of financial reform.

A wave of financial reforms started in 1993, when inflationary pressure increased as a result of booming investment. After realizing that measures to control inflation would not be effective without a modern financial system, the central leadership decided to embark on a new program in financial reform in 1993, led by vice-premier Zhu Rongji. The reform program consisted of four major components: 1) separating policy lending from commercial lending by setting up policy banks; 2) deregulating the banking sector and establishing new banks; 3) improving the legal framework of the financial system; and 4) developing financial markets.

Three policy banks were established in 1994, designated to be the main vehicles for policy-based lending in the future. These three policy banks are the State Development Bank, the Agricultural Development Bank, and the Export-Import Bank of China. The establishment of these policy-lending banks was intended to pave the way to a further commercialization of state-specialized banks.

In addition, the banking sector started to deregulate and lower barriers to entry. As a

result new non-state commercial banks were established. These banks included nationwide commercial banks, regional banks, savings banks, and private banks. Foreign banks and financial institutions entered China's market and some of them were permitted to conduct domestic currency business.

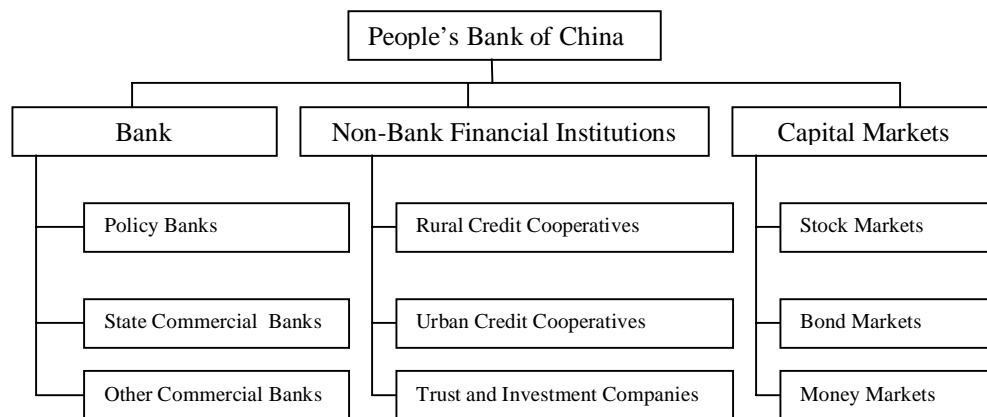
Another dimension of financial reform in this period was improvement of the legal framework for a market-based financial system. Several important laws regarding operations of financial institutions were promulgated. In March 1995, the *Central Bank Law* was passed by the National People's Congress. It defined the functions and legal status of the People's Bank of China as the central bank. Under this law, the PBC gained more autonomy and saw its role focused on maintaining monetary stability and the stability of the financial system. Subsequently, the *Law on Commercial Banks* was promulgated in May 1995, aiming to transform state commercial banks into real commercial banks. The passage of these laws marked a further step in building a strong, comprehensive, and relatively independent banking system in China.

Financial markets were further developed and market-based monetary instruments were increasingly used during this period. This included further expansion of stock exchanges in Shanghai and Shengzhen development of a secondary market for government securities, and development of a money market--the inter-bank market. In addition, the central bank increasingly employed interest rate adjustments and reserve requirements to manage liquidity in the financial system.

Present Characteristics of China's Financial System

As a result of the different phases of the reform, the financial system is now comprised of three components: the banking sector, then non-banking sector, and the financial markets. The main component, banking sector, is made up of the central bank, the four state commercial banks, three policy banks, and other commercial banks. The second component, non-bank financial institutions, includes the rural and urban credit cooperatives¹¹, and trust and investment corporations. The third components include stock and bond markets, as well as other financial markets. The present structure of the financial system is shown in Figure 3.1.

Figure 3.1 Structure of Financial Sector in China



After 20 years of reform, however, the state banks still dominate the financial sector. In 1996, the state banks, including the central bank, the four state commercial banks, and three Policy banks controlled 85 percent total assets, granted 80 percent of total loans, and took three quarters of total deposits of all financial institutions in China, as shown in Table 3.1.

¹¹ Urban Credit Cooperatives in some large cities were upgraded to bank status in 1996 and their names

Table 3.1 Distribution of Assets, Deposits, and Loans by
Types of
Financial Institutions, 1996(In Percent)

Type of Financial Institution	Assets	Loans	Deposits
Banks	84.6	80.7	76.5
State Banks	82.1	77.5	72.3
Other Banks	2.5	3.2	4.2
Non-banks	15.4	19.3	23.5
Urban Credit Cooperatives	3.2	4	5.8
Rural Credit Cooperatives	8.2	10.4	12.8
Trust and Finance Companies	3.0	3.9	4.9
Total	100	100	100
(Billion Yuan)	(7,697.1)	(6,115.3)	(6,857.1)

Source: Report of People's Bank of China (1997)

Despite the significant strides made in reforming the banking sector, banks in China--in particular the four state commercial banks--cannot be characterized as modern, efficient banking institutions. Although three policy banks were set up to assume policy lending, the four state commercial banks have not yet been able to operate on truly commercial terms. For example, the policy banks did not take over the stock of policy loans of the state commercial banks, and state commercial banks are still controlled by the government and required to finance the state-owned enterprises. Due to the dominance of policy lending, state commercial banks have low asset quality and require significant restructuring and recapitalization. State commercial banks have also failed to adopt modern management techniques such as asset-to-liability management, loan risk assessment and loan monitoring. Non-state commercial banks are small compared with the state commercial banks, and only play a minor role in the banking system.

were changed to urban Cooperative Banks, correspondingly.

Lessons of US Financial Market to China's Financial Reform

In this section, I review the history of the US financial market with an eye to derive lessons for China. Because of vast differences between China and the United States and the development of their financial systems, it would seem that there is little relevance of US experience to policy-making in China. This is not the case. All of the failed policies in the United States in the 1980s have been observed in the economy of China in the 1990's.

US Financial Market Experience

Most major policy mistakes in the United States which have caused dislocations or reduced effectiveness of US financial system can be discussed as: government guarantees for financial institution liabilities or financial instruments, efforts to segment financial services markets, policies to control speculation, and finally, efforts to design or control the financial system according to a policy objectives or theory.

Financial Guarantees

A great deal of attention of economic analysis has focused on the role of the financial system in terms of money. Because of the importance of deposit money as a medium of exchange, many governments have focused special attention on the preserving the perception of safeness of bank liabilities, mainly deposits, to avoid the costs of panic-induced deposit withdrawals, forcing liquidations of assets at "fire-sale" prices and inefficiencies associated with a flight from deposit money. Possible breakdowns in economic activity due to extreme concern about the security of the payments systems

limiting transactions to barter or, worst, an end of commerce, justifies regulators' concern with preserving confidence in bank and thrift deposits. For that reason, the most important use of official financial guarantees backed in the United States has been deposit insurance. But many other financial guarantees not related to money have been granted by policy-makers, for example the "too big to fail" doctrine for large bank liabilities and many types of credit guarantees intended to foster specific credit flows. Financial guarantees have a high cost because they distort relative prices and perceptions of risk and more importantly distort the incentives of managers of financial institutions. Furthermore, guarantees create value for powerful financial market constituencies that become addicted to them — financial guarantees rarely go away once created.

(1) Deposit Insurance

Deposit insurance is credited by most financial market observers to have been the essential factor in the savings and loan crisis, which is estimated to have cost US taxpayers upward of \$150 billion (Lavigne, 1999). Because savings and loan liabilities in the form of deposits were guaranteed by the government, they were no risk to depositors. Savings and loans were granted expansive new powers in the 1980s. Management incentives to maximize returns led the entire industry to obtain the maximum amount of funds through deposits insured by the government and to invest those funds in the highest expected return, hence highest risk, investments allowed by regulation.

Deposit insurance undermines not only the incentive structure of the management of deposit-taking institutions, but can also distort the willingness of regulators to recognize inevitable losses in a timely fashion. This is precisely what happened in the United States, when early problems with thrift losses in the early 1980s resulted in a

reduction of capital requirements.

(2) Too Big to Fail

During the 1980s, US bank regulators pursued a policy of implicit financial guarantees on the largest banks and financial institutions by assuring non-deposit creditors that important banks, like Continental Bank, would not be allowed to fail, or if they did, all creditors — including uninsured creditors — would be protected. The theory was that a large failure would disrupt the financial system, so-called systemic risk destroying confidence and possibly the entire economic system. On the other hand, most observers argue that allowing large failures early in the 1980s would have put the large creditors to banks, mainly corporations and financial institutions, on notice to be wary of risks and could have avoided the large problems later in the decade. The Continental Bank bail-out in the early 1980s had the effect of reducing financial market participants' concern with large bank risks. Since governments cannot eliminate economic risk, the too big to fail doctrine could not be sustained and was officially dropped by Congress in 1991.

Segmentation

US financial markets have been highly segmented, with insurance and investment banking legally separate from commercial banking. The losers are consumers of financial services. The costs of financial market segmentation in economic efficiency from reduced competition is augmented with the losses due to difficulty for laws and regulations to adjust to changing market conditions.

The Glass Steagall Act separating investment banking and commercial banking has

prevented banks from realizing synergies available from combining the offering of credit directly with the possibility of arranging funds through public or private placements of debt issues.

The Bank Holding Company Act and amendments prevent commercial bank control of the economy through large size and control of non-financial firms. The unintended effect was to protect insurance companies and their inefficient sales structure relying heavily on independent insurance agents. Sales and distribution of insurance have until recently been dominated by independent agents who charged extremely high sales commissions. The unintended effect of restrictions on bank holding companies has been the stifling of competition in an important insurance market.

Controlling Speculation

Speculation is considered by many to be an evil. Critics of speculation believe that speculators gain by others' mistakes that speculators do not create real value, and that speculators can create over-inflated or over-depressed prices and profit from illusory bubbles or crashes. However, economists know that speculators perform a real economic service in bearing economic risks on behalf of producers and consumers who would rather not worry about future prices or rates. Furthermore, speculation is not just performed by flamboyant individuals with instantaneous access to sensitive financial markets. Every importer who delays payment, or every manufacturer who stores large inventories, is speculating. In the United States, as in China, speculation has a bad reputation and policies have been implemented to control speculation. Nearly all of these efforts have proven to be mistakes.

(1) Margin Requirements

After the Stock Market Crash of 1929, following a presumed speculative bubble, the Federal Reserve was authorized to control the purchase of securities on credit. These restrictions remain, although they are not often important. The reason that these restrictions are not too important today is that it became clear in the past that use of margin requirements to control “speculative” activity was itself a source of enormous market risk. Furthermore, there were present among market participants, principally brokers, exchanges, and their customers, incentives to provide less intrusive controls on excessive use of credit for securities purchases.

(2) Prohibited Instruments: Put Options

Concerns about speculation have led to strange policies. For example, when the Securities and Exchange Commission (SEC) authorized trading in call option contracts, it chose not to authorize put option trading. But by deciding that put options were “more speculative”, the market was made less efficient because risk-takers were less able to tailor their price risk. Furthermore, options are not used exclusively or even predominantly for speculation. They are widely used to reduce risk. The use of options to shift and tailor risk exposure has been one of the most important developments in modern financial markets. These developments occurred, however, in spite of at times serious resistance by regulators and firms specializing in the trading of traditional financial instruments.

Controlling Financial Channels and Designing Financial System

Government policy makers often believe that they can plan a financial system. US

experience suggests that planning does not work — markets work too fast. What is particularly interesting about such efforts to control or design parts of a financial system is that they create their own rigidities, making it hard to remove the distortions.

Economic forces will strain against barriers to competition or restrictions on fair returns. Interest-rate restrictions were untenable in the 1980s. When rates were finally freed, financial institutions had to make adjustments in a disastrously short time period, rather than gradually developing their abilities to deal with changing market conditions over a longer time period. If interest rates had not been regulated, and portfolios not restricted, deposit-taking institution officials would have learned through relatively painless trial-and-error rather than through catastrophic short-term changes.

Relevance of US Experience to Financial Reform in China

In this section, I have maintained the topic outlined from the above, stressing the problems facing China in the future evolution of its financial system, which parallel challenges facing US policy-makers in the 1980's.

Of course, the main difference between China and the United States is in the dominance of state ownership of assets in China. This includes the banks. Furthermore, previous Chinese policy in terms of designing a financial system raised banks to a prominence never seen in the United States. Banks are nearly the exclusive repositories of household savings in China. In the United States, insurance and securities investments have always been important alternatives to bank deposits as savings. Furthermore, the US has always had competitive financial markets.

The role of state-owned banks in China remains dominant despite recent efforts to

redefine the role of some of the banks as commercial banks and others as “policy banks” performing government functions. There has been very little progress in converting Chinese banks, and the vast household deposits they hold, into a free and competitive banking system.

Financial Guarantees

The importance of deposits as the only significant means of household savings means that allowing banks to fail when their assets, primarily loans to SOEs, go bad, would be accompanied by enormous political costs as households’ most important assets were threatened. Allowing banks to fail is felt by most China observers to be a cost too large to be borne by the Chinese government. This leaves policy-makers with only a few alternatives, all of which interfere with efficient investment and economic growth in China. Banks may be encouraged to diversify in order to derive profits from new and unfamiliar businesses, such as riskier lending to high potential return projects, in order to grow out of the bad-debt problems.

Government underwritten deposit insurance is a policy that may someday tempt Chinese policy makers. The large portfolios of non-performing state-owned enterprise (SOE) loans in Chinese bank portfolios will make deposits at those institutions less desirable than other forms of savings which would emerge in partially regulated and informal markets, such as deposits or notes from non-banks or newly chartered banks. To prevent the deposit withdrawals that could force recognition of bad loans at existing banks, government officials will be tempted to insure the old bank deposits. The incentive effects of deposit insurance, in view of US experience, could unleash further

risky expansion of insured banks at the cost of more productive investments elsewhere in the economy.

Segmentation

Chinese financial institutions are not as segmented by regulation as US financial institutions simply because bank deposits are already so important that other means of savings and sources of financial services are minor factors in the markets. However, there may well be a temptation in the future for Chinese policy-makers to limit the products and services offered by non-bank financial intermediaries when the inevitable banking crisis occurs. These measures will likely result in more financial market segmentation to protect against widespread deposit withdrawals. For example, in the United States, banks were allowed to offer insured deposits, which competed with money-market mutual funds in terms of rates but had government insurance, limiting the attraction of managed funds to savers.

The attractiveness of many savings instruments depends on how readily they can be converted to cash for payments purposes. Non-banks were denied direct access to the payments system in the United States. In China, prohibiting access to the payments system to limit the attractiveness of non-bank savings instruments would be easy to adopt and enforce because of the small number of institutions.

Given the dominance of deposits in household savings, a critical issue in China will be whether policy-makers will allow the development of alternative savings instruments offered by non-banks. In the United States, the development of securities markets and mutual funds was advanced by the 1980s, therefore policies to limit the

development of savings instruments alternative to bank and thrift deposits could not be too effective. There was little regulators could do to stop funds from moving out of deposit-taking institutions. In China, on the other hand, securities markets and managed funds are fledgling activities. If banks weaken notably such that the willingness of savers to hold deposits erodes, Chinese policy-makers may reduce the danger by segmenting markets and limiting competition from non-banks for household savings.

Controlling Speculation

In China, futures markets have been closed several times due to excessive “speculative” activity. The fact that some traders may make large profits from a change in expectations should not obscure the value of trading in instruments which can be used not only to speculate but also to hedge risk. The US experience suggests that efforts to control speculative markets either diminishes their value to the economy or forces them to close or move elsewhere. One of the most important roles of financial markets is creating liquidity. Closing any market because of fears of speculative fever is very costly to the effective functioning of the financial system both in terms of the specific market interruption and the impact the policy has on investors’ confidence that other markets will remain open and liquid.

Risk exists in all economies and cannot be eliminated by government policy. Financial markets serve to distribute and price risk. The bursting of speculative bubbles is a necessary experience to make risk a compelling part of savers’ calculation, not only in emerging markets but also in established markets. Controlling speculation also limits the ability of investors to hedge risks stemming from their balance sheets or operating

activities. Yet experience in the United States suggests that it is very difficult, if not impossible, to tell the difference between speculators and hedgers. Restrictions on speculation can be very costly to the functioning of financial markets.

Controlling Financial Channels and Designing Financial System

In the United States, as discussed above, certain markets and activities were favored by the design of the regulatory system, producing imbalances and rigidities which contributed to the bank and thrift crisis of the late 1980's. The key point about financial systems is that they evolve in response to needs of the economy to the extent they are not restricted. Confining savings flows to certain channels to promote favored investments, like housing in the United States or export industries as in Korea, have the effect of creating imbalances and bottlenecks. Stiff regulation may control or influence market forces and savings flows for indefinite time periods, but pressures will build up against inefficiencies and price controls which make the ultimate adjustments more costly.

It is very challenging for the Chinese policy-makers to design an appropriate financial system for its economy. The task is too dynamic and too complex. By delaying the recognition of existing inefficiencies and losses, the costs of restructuring the system only increase. It is true that the financial system development in China would be unique, reflecting China's history, culture, and legal environment. The system should be, to the extent possible considering real political concerns, allowed to evolve naturally. The economic forces which would shape the Chinese financial system should be allowed to play freely, and not be distorted or twisted by short-term policy objectives which in the

long run increase the costs of adjustment and retard development.

Important Lessons from US Experience for China

In this section, I will summarize the important lessons to be learned from US experience for China's financial reform. First, deposit-insurance and other financial guarantees relying on government's power are tempting for policy-makers facing a lack of confidence in financial institutions, specifically deposit-taking institutions, in order to calm investor concerns and avoid painful adjustments in the financial system. The temptation to use the power to protect specific institutions is pervasive and invariably produces costly distortions in financial flows and management incentives. Second, market segmentation prevents healthy competition and creates barriers between financial markets that are inefficient but can be difficult to remove. Further, stifling the creation of innovative markets and instruments can increase the cost and retard the development of the financial system into its required role in a growing economy. Third, policy-makers' attempts to control presumed unhealthy economic activity such as speculation can have unintended effects reducing the flexibility and usefulness of financial markets. Finally, efforts to design and control financial systems through activity limitations and pricing controls can produce inefficient and wasteful policies on the part of financial institutions and markets and may be harder and more costly to remove after the accumulation of distortions and establishment of privileges over time.

What is the relevance of these lessons for China? First, China's financial system has not really evolved much: many of the implications of the US experience can be translated into a policy committed to few restrictions on financial institutions and their

activities and a tolerance for experimentation and failures early in the development of the system. However, the main practical issue facing China's economy is the creation of financial institutions that can increase the provision of the financial services to promote economic development and efficiency. The large problems resulting from historical evolution, namely large banks with large portfolios of low quality loans, cannot be eliminated by financial system design. These problems will be reduced in significance if they are not allowed to grow bigger and are allowed to decline in relative importance as the rest of the economy grows. Policies built on a strategy of delaying and hiding real economic inefficiencies, either by retaining funds in banks through deposit insurance and guaranteeing credits to SOEs, by designing special purpose institutions intended to solved specific policy problems, or by limiting competition and activities of financial institutions, delay the inevitable marking of bad assets to market values. More importantly, they deny China the important real benefits the full range of financial service required to develop a healthy financial system.

Strategies of the Financial Reform in China

The creation of a modern financial system is not only essential for improving the efficiency with which capital is allocated; it is also closely tied to improved macroeconomic stability, capital account convertibility, and other important economic policy objectives. This section discusses the financial reform strategies that are most likely to allow banks and other financial institutions to fulfill their role of allocating capital efficiently, thus paving the way for the achievements of these objectives.

Bank Recapitalization

As to the process of recapitalizing and restructuring the banks, the US also confronts similar problems. A variety of techniques have been employed, such as taking bad assets off the balance sheets, capital injections, mergers and acquisitions (Rose, 1995). However, the balance of concerns is markedly different in China from the US. The main focus for China should be to provide the right incentives going forward. Thus, a key part of the strategy should be to solve the "bad loans" (nonperforming loans) associated with the state-owned banks.

In China, the magnitude of nonperforming loans and thus the size of the required recapitalization are so large that the gradual rebuilding of capital through the reinvestment of profits does not appear viable. The gradualist approach, sometimes called a flow solution, is feasible in the mildest cases of banking distress, where capital adequacy of problem banks while low is still positive. However, several of China's major state-owned banks on a proper accounting are insolvent; that is, the value of their liabilities exceeds the value of their assets and their capital adequacy is negative. Moreover, the reported level of profitability of these banks is quite low and almost certainly negative on realistic accounting principles. In short, there are no real profits to be added to capital. So, the "bad loans" problem is really a challenge to the financial reform in China at this point.

The specific recommendations of the World Development Report for implementing a flow solution—liberalization of interest rate on loans, elimination of quasi-fiscal demands on banks, more realistic provisions for loan losses, and so forth—are essential for China (Fanelli, 1998). But they are most regarded as reforms that will allow Chinese

banks to maintain their capital adequacy and operate on a commercial basis going forward after recapitalization, rather than steps that could increase profitability by enough for the banks to solve the problems arising from the historical accumulation of bad loans.

Reconstructing the Central Bank System

Through the implementation of monetary policy, the central bank plays a crucial role in a country's macroeconomic stability. While the credibility of monetary policy itself can improve its positive effect on stability, the independence of the central bank in formulating and implementing such a policy can help ensure its effectiveness and efficiency. Also, central bank independence can contribute to establishing and maintaining the credibility of monetary policy. There has been increasing attention paid to promoting monetary stability through the establishment of an independent central bank.

In 1984, the People's Bank of China (PBC) became China's central bank. However, the monetary and credit policy continued to take the form of a credit plan that was implemented through a set of credit quotas for each bank and direct bank financing of enterprises. Since the credit plan was an aggregation of sectoral and local financing needs done from the bottom up, an expansionary bias was inherent in the system. This impaired the PBC's ability to manage new monetary developments. The Central bank received a new impetus in 1995 when this law was enacted, giving the central bank the legal foundation of operate in a market environment under the leadership of the State Council. In 1998, the central bank further replaced its 31 provincial branches with 9

cross-province regional branches as in the U.S. Federal Reserve System. This reform further minimized the local governments' influence on monetary policies.

Over the reform years, the organizational structure of the PBC, which mirrored the administrative structure of government, changed little. The number of offices actually is too large. The structure of the bank's branch network made it difficult for the head office to have an effective control over its branches. At the same time, branches had remained vulnerable to pressures from local government. The reason is that the local governments controlled the welfare benefits of bank employees and, before 1988; they also controlled the appointment of senior branch employees. In these circumstances, it was difficult for branch officials to strictly comply with the monetary policies from the head office and to resist local governments' pressure to extend loan facilities, especially to local enterprises. It was thus common for the initial planned monetary targets to be almost always exceeded by the end of the year. In effect, monetary targets, particularly the size of loans, were driven by the investment demand of local governments and the needs for financing real sector expansions (Totten, 1992). So, the reform of the structure of PBC in 1998 represents a big step forward in China's financial reform.

Strengthening the Role of PBC in Implementing Monetary Policies

The People's bank of China already possesses an almost full complement of indirect monetary control tools: reserve requirement, open market operations discount facilities, and loans to banks. However, though well equipped, it has conducted monetary policy in effect only through the credit plan. The result of this failure to use indirect monetary policy instruments has created a bewildering set of reserve requirements in

China. Banks are required to hold 13 percent of reserves and another 5 to 7 percent excess reserves against their deposits, a total of 18 to 20 percent. Moreover, the 13 percent of the required reserves are frozen assets and only the excess reserves can be used to settle payments (Sung, 1993).

This peculiar arrangement came out of the operations of the credit plan. To meet the ever-rising funding requirements of the credit plan, the central bank has supplied a rising volume of reserves through lending to banks. This resulted in mounting bank reserves, which became excess reserves whenever the credit plan was the binding constraint in credit extension. To mop up the resultant excess reserves, the PBC froze the required reserves and slapped on top of them excess reserve requirements. Excess reserves continued to accumulate. Normally, in a market where a reserve-based, indirect monetary policy is operative, the excess bank reserves would signal a monetary policy out of control and rising inflationary pressure. But, not in China, where the effective monetary control has been the credit plan, any of the indirect monetary policy tools.

The planned shift to indirect monetary control, therefore, would necessitate a thorough house-cleaning to sort out the various existing, but hitherto unused, policy tools and get them in shape for use. Specifically, means must be found to mop up the huge accumulated excess reserve. One way would be for the central bank to issue a bond to mop up the excess reserves. The bond issue could be sold by auction to banks only. It would be redeemable only when called by the central bank, and in amounts to be determined by the central bank as a means to inject reserves into the economy. Since the initial issue could be as large as desired, the central bank could use the opportunity to combine the present excess and regular reserve requirements and lower the total to say 10

percent, without the expansionary effect on the money supply usually associated with a reduction in reserve requirement.

The bond would not be counted as part of reserves, but it could be marketable among banks so that a bank with good lending opportunities could obtain additional reserves by selling its bonds to another bank with surplus reserves. To the extent that the bond is as transferable as bank reserves, this would turn into another inter-bank market parallel to the existing inter-bank funds market, to facilitate banks' liquidity management. Like the inter-bank funds market, the inter-bank bond market would not affect the total reserves.

In addition, the central bank should experiment with various indirect monetary control tools to see which one would serve best. From US's experience, the choice is between open-market operations and lending to banks (Eakins, 1991). Both provide the flexibility and effectiveness needed for monetary policy. Open-market operations might appear to have the advantage of non-arbitrariness in the distribution of reserves, but the same effect can be achieved if lending to banks were operated on an auction basis to achieve allocation through the price mechanism. Lending to banks has the advantage of minimal extraneous requirements, such as well-functionary money markets, which China currently lacks.

Lending to banks by auction is quite different from the discount facility of most central banks, including China's, that makes reserves available on tap; that is, open to all qualified institutions that come with eligible paper. In contrast, lending to banks by auction would distribute reserves on a fixed schedule, say, weekly, for a pre-announced amount of reserves. The interest rate would be determined by the market, not set by the

central bank as in the case of the discount rate. This new facility could exist side by side with a usual discount facility available on tap, such as used by the German central bank, with the former adjusting the banking system's total reserves and the latter assisting in individual banks' reserve management (Fischer, 1997).

Whether open-market operations or lending to banks by auction is chosen as the principal monetary policy instrument, in either case interest rates must be allowed to vary and the banks must be truly market-oriented. Neither condition exists in China today. Both are challenges that the monetary authorities must meet in the next several years if financial reform is to succeed.

Increasing Competition

The most important policy tool to enforce commercial discipline on banks is to increase competition. Despite the growth of new banks, the share of the specialized state-owned banks in the financial system remains quite large and in comparative terms China's largest banks control a huge amount of assets. China's largest banks account for a usually high share of credit creation.

All possible steps to increase competition should be pursued.

First, the People's Bank of China should allow those banks created since reform began that have accumulated sufficient experience in evaluating credit risk to expand their operations more rapidly once the recapitalization of major state banks has created a more level playing field. These banks are likely to be stronger institutions, such as Merchants Bank etc. However, the PBC has restricted the development of these new commercial banks' branch networks, in part to protect the large state-owned banks.

Second, the central bank should allow foreign banks and other foreign financial institutions gradually to expand their domestic currency business by easing the geographic and other constraints it imposed on the handful of foreign banks it allowed to enter the domestic currency business in 1997. The central bank should allow foreign financial institutions broad access to the renminbi lending market by easing the prevailing geographic and client restrictions. Initially the funding of foreign financial institutions could continue to be through the interbank market for shorter-term funds. They should be allowed to sell domestic bonds to Chinese financial institutions to finance long-term lending. Within a relatively short period of time, perhaps two to three years, the central bank should allow foreign banks to take renminbi deposits directly from Chinese enterprises and institutions as well as the public. This approach, which liberalizes most rapidly on the lending side, takes immediate advantage of the ability of foreign financial institutions to assess credit risk while giving domestic institutions a brief interlude before they would have to compete on the deposit-taking side of the banking business.

Third, the state should allow the creation of genuinely private banks. These new institutions should be subject to an appropriate minimum capital requirement and standards that ensure their independent control and management. This is especially important to avoid the situation emerging in Russia in which many new banks are thinly capitalized and controlled by enterprises with which much of their business is conducted (Cecchetti, 1999).

Fourth, foreign banks and other institutions should be allowed to buy shares of existing banks, regardless of whether they are publicly or privately owned. The Asia Development Bank's purchase of a small stake in the Everbright Bank in 1997 is a

promising precedent (Fanelli, 1998). Besides its purchase of shares in Everbright Bank, the Asian Development Bank has launched a technical assistance program to strengthen the EBBC (Everbright Bank of China) institutionally and operationally so as to provide a role model for the commercial banking sector in general. The program provides equipment and software, consulting services, and staff training.

The resulting substantial increase in competition in the banking industry will place substantial pressure on the large state-owned banks. As currently configured they probably cannot and almost certainly should not survive. Most important, China's largest banks are grossly overstaffed and, as a result, have unusually low ratios of assets per employee. So, there is need for the amalgamation of branches of such large state-owned commercial banks. Provincial and city branches of them should be gradually amalgamated. At the same time, there is need to reduce the number of employees and improve the efficiency.

Strengthening Bank Supervision and Prudential Regulation

Simultaneously, banking supervision must be further strengthened. For example, all banks must be subject to stringent external audits, and criteria for classifying loans as non-performing must be brought into compliance with international standards. In particular, classification should be based on failure to make interest payments on a timely basis rather than being tied entirely to repayment of principle. China's system of loan loss reserves also needs to be overhauled so that the magnitude of reserves banks are required to set aside is linked directly to the quality of each bank's loan portfolio rather than set at some arbitrary low percent of total loans. The international practice, and the practice in

other transition economies, of requiring 20, 50, and 100 percent reserves for past due, doubtful, and bad loans, respectively, should be adopted (Zhou, 1992).

Ultimately, a competitive market can provide the most effective discipline of banks. But, this depends critically on transparency. Most Chinese banks fall short of meeting this standard. For example, among the four largest state-owned banks, only the Bank of China discloses information on the quality of its loan portfolio and the magnitude of nonperforming loans written off annually. And, again except for the Bank of China, the largest state-owned banks do not present their balance sheets on a consolidated basis, allowing them to bury financial losses in their subsidiaries. More generally, both profit and loss statements and the balance sheets of most banks are presented on such an aggregated basis that it is difficult to evaluate their true financial condition (Ash, 1996).

Interest Rate Liberalization

A key step in the sequence of reforms outlined here is the simultaneous gradual liberalization of interest rates and the eventual complete phasing out of the credit plan. Under the credit plan, interest rates have been used only to attract bank deposits, but played little role in credit allocation.

The system prevailing in the first two decades of reform, in which lending rates were fixed by the central bank and adjusted very slowly, guarantees that excess demand for funds emerges strongly whenever inflation rises, causing falling and sometimes even negative real interest rates. That necessitates the administrative allocation of limited credit resources, creating the potential for enormous corruption. Privileged firms, most often state owned, that are allocated funds may find it more profitable to lend them at

higher interest rates in informal credit markets rather than using the funds themselves. Although the informal credit markets may facilitate the flow of funds to higher-return investments of borrowers who do not have access to bank credit, this has unfortunate side effects. The implicit subsidy to the initial preferred borrower is often converted into illegal private income that accrues to individuals in the borrowing firm who are able to place the funds in the curb or informal credit market. And depositors lose because the artificially low interest rate the banks charge on loans ultimately is financed by unusually low rates of interest that banks offer to households on their savings.

However, interest rate liberalization, must be carefully coordinated with other elements of the financial reform package. In particular, premature liberalization of deposit rates could undermine the goal of requiring banks to operate on commercial terms. Without a prior or simultaneous free of lending rates, freeing deposit rates would result in a substantial squeeze on bank margins, drastically reducing their already low level of profits. Since freeing lending rates on average would raise the rates paid by borrowers, that step cannot be taken prior to the transformation of the relationship between banks and state-owned enterprises.

Developing Comprehensive Financial Markets and Financial Instruments

In China, the development of financial instruments has been limited to the capital market. No nationally integrated money market has as yet been developed, and most banks lack the skills to develop new products that could create competition in the financial sector. Local interbank centers have been emerging since 1986. Although they have played a useful role in the local redistribution of surplus funds, they have not

operated as interbank markets in the traditional sense. Since nonbank financial institutions and even some enterprises can participate, these centers often serve as channels for long-term financing of nonbank and nonfinancial institutions, thereby circumventing the credit plan.

The absence of nationally organized money markets—one of the salient features of China's financial sector in the early 1990s—is related to its slow start on interest rate liberalization, its lack of modern payments and settlement infrastructure and the banks' inefficient administrative organization (Zhou, 1998). The lack of nationally integrated interbank and money markets has, in turn, hampered efforts to achieve the transition to indirect instruments of monetary policy. In the absence of an interbank market where surplus funds could be redistributed, the existing indirect instruments have been used to channel liquidity from one region or entity to another. The authorities have regulated liquidity by adjusting reserve requirements and using the PBC's lending facilities for banks while maintaining relatively stable interest rates.

Capital market development, thought, has become one of the striking features of China's reform process. In 1981, the authorities resumed the issuance of government securities, mainly to complement financing provided through the credit plan. Shortly thereafter, the authorities permitted the issuance of other types of bonds—including enterprise bonds—and enterprise shares, even though they remained strictly controlled in order to avoid conflicts with the priorities set in the credit plan. Since 1998, secondary markets in bonds and stocks have been allowed to operate, which has further boosted capital market development. The stock exchanges of Shanghai and Shenzhen have become the exponents of China's flourishing capital market activity (Cao, 1995)

Improving the Financial Order

Improving the financial order is also an important component of the financial reform. Financial activities should be strictly in accordance with the laws.

One aspect of institution building that wasn't paid sufficient attention during the first decade of reforms is the enactment of legislation to support financial market development. Central bank and commercial bank laws were enacted as recently as 1995, while other key legislation, covering such subjects as non-bank financial institutions and negotiable instruments, is still in preparation. The lack of a solid legislative underpinning has certainly had an adverse impact on China's financial reforms. For instance, as emerging market forces began to have an impact and the financial system expanded, the need to strengthen the supervisory authority of the PBC was strongly felt. Initially, the PBC's relationship with the state-owned banks was only that of *Primus inters pares*. The PBC managed gradually to establish its authority over the banks and the newly emerging parts of the financial system. Yet the country's political and administrative structure and the tendency to decentralize decision making, in combination with a lack of supporting legislation, initially gave the local authorities more influence over PBC branches and branches of the specialized banks than the PCB's own headquarters had. This unsatisfactory situation was finally addressed by the 1995 central bank law, which established the authority of the PBC headquarters over its branches and the financial sector as a whole.

Likewise, the lack of solid legislation has delayed the commercialization of the state-owned banks. Their protracted dependency on the government and its policies has

resulted in their failure to develop financial sophistication and prevented them from making more effective use of market instruments in their operations.

The Political Economy of the Financial Reform in China

In this section, I will discuss the possibility of practicing some strategies of the financial reform in the context of political economy in China.

Central Bank Reform

In China, the independence of the central bank from the government may be totally possible only after the government reform in China. Now, the PBC is defined as part of the government or a government organ. In this sense, autonomy is perhaps a more appropriate word in discussing the issue. The PBC's independence within government rather than from government, that is, autonomy, and the relevant issue of the objective of the monetary policy has been recognized.

It is well known that the PBC had limited autonomy or independence in both formulating and implementing monetary policy. Monetary policy was in practice made subordinate to fiscal objectives and the government's general economic growth targets. The PBC's implementation of monetary policy was also subject to interference from government.

Interest Rates Deregulation

Although China has begun to liberalize short-term interest rates in the interbank market, it will not be able to free up interest rates on deposits as long as the largest domestic banks and their principal borrowers remain financially fragile. Besides, the

state-owned banks benefit considerably from the People's Bank policy of setting artificially low interest rates on sight deposits. For example, in 1995, when inflation as measured by the consumer price index was 17.1 percent, households received only 3.15 percent interest on their passbook savings accounts while borrowers paid only 10.98 percent interest on one-year working capital loans (Walder, 1996). Deregulation of interest rates in 1995 certainly would have raised the interest rate on sight deposits to at least on one-year working capital loans to about 21 percent. Since household savings in the form of sight deposits during 1995 averaged RMB 530 billion, banks received an implicit subsidy from households of approximately RMB 74 billion (Walder, 1996). In turn, the banks passed this subsidy on to their borrowers in the form of artificially low interest rates on loans. Thus, while the World Bank has long recommended that the People's Bank introduce greater flexibility in interest rates, it seems unlikely that this will be possible on the deposit side as long as banks are financially weak and dependent on access to very low-cost household deposits (Knight, 1999).

Decontrolling interest rates on loans is an essential part of a strategy of reducing fluctuations in economic activity and the more general liberalization of interest rates.

Capital Markets

Normally, after economic development has proceeded for some time and per capita income has risen significantly and appropriate legal and regulatory structures have been created, markets for equity and corporate bonds come to play an important supplementary role to banks in the allocation of capital (Cao, 1995). Bonds can be more effective than

banks in providing long-term capital for infrastructure and other project with long gestation periods.

In China, a weak banking system and an inefficient state-owned enterprise sector constrain the development of capital markets for at least two reasons. First, capital markets must rely on well-functioning banks to process payments and act as custodians. Besides, in China the state cannot allow unfettered competition for funds if banks are fragile. On the other hand, that process would undoubtedly reduce the share of funds flowing to state-owned firms, forcing many of them into bankruptcy.

In addition, in China, households have been willing to place most of their savings in the banking systems. The public appears to have confidence in banks.

New Domestic Banks and Foreign Banks

A similar logic constrains the development of new banks and foreign banks. Since these institutions begin without the handicap of a large portfolio of nonperforming loans, they will achieve higher profitability than existing large state-owned banks. They can use these higher earnings to offer depositors better services or, if interest rates were deregulated, to offer higher interest rates on savings. In either case the specialized banks would be less competitive. Allowing new domestic banks to expand their franchise rapidly would almost certainly reduce the flow of funds into the existing state banks. That, in turn, would impair their ability to increase their lending to their traditional borrowers, state-owned banks. China probably will constrain the development of new domestic financial institutions.

The authorities may continue to limit the ability of foreign banks to carry out domestic currency business for the reason. Besides, the prerequisite of introducing foreign competition is to strengthen the central bank's monetary management and financial supervision. So the development of foreign banks in China will be constrained in the future.

Attaining Capital Account Convertibility

China formally achieved convertibility on current account transactions in December 1996. That means that the renminbi can be readily traded for foreign currency to be used to finance trade and service transactions.

Chinese leaders repeatedly have said their goal is to make the renminbi fully convertible, meaning that Chinese firms and individuals would be able to purchase foreign currency to be used to buy foreign currency denominated financial assets. No target date, however, has been announced. Since full convertibility would represent a dramatic expansion of the range of financial assets available to Chinese households, it poses the threat of disintermediation and thus could undermine the financial viability of domestic banks. Besides, one of the lessons of the Asian financial crisis of 1997 is that countries with weak banking systems are advised to maintain the combination of capital account convertibility and fixed or heavily managed exchange rate systems.

Thus China's move to capital account convertibility must be closely integrated with domestic financial market reforms, particularly strengthening its fragile, undercapitalized banking system. The central bank, furthermore, must relax its heavy regulation of domestic interest rates and allow interest rate liberalization. Unless domestic interest rates

are internationally competitive, when capital account convertibility is introduced there will be substantial pressure on the balance of payments and the exchange rate, as well as the potential for disintermediation.

CHAPTER IV

CONCLUSION

After more than twenty years of economic reform, much had been accomplished but much remains to be done before China becomes a market economy and realizes its full potential. In this thesis, I highlight two major areas that may pose the most serious challenges for China: state-owned enterprises and the financial system.

In this paper, I characterize the progress of China's reform of its SOEs in two areas: privatization of small SOEs and mass layoffs. My main thesis is that privatization, Chinese style, rests on the political economy of China. Privatization led by the local governments works reasonably well because these governments are in a better position to address economic and political issues through localized privatization programs. More importantly, I argue that the government structure of China provides the local governments with the incentives to privatize. Harder budget constraints combined with increased competition from the non-state sector to yield strong financial pressures for many local governments to address SOE problems.

From the perspective of cross-country comparisons, privatization, Chinese style, also differs considerably from privatization in Eastern Europe and the former Soviet Union. State-owned enterprise reform in those economies is far more centrally driven. But I note here that the pattern underlying state-owned enterprise reform, Chinese style, is not an accident. There is a political logic for it. Again, the initiatives of local

governments and the tolerance of, and later promotion by, the central government are predictable consequences of the political economy in China. Such perspective provides important insights to the economic and political dynamics underlying privatization, as well as other reforms, in China. Indeed, reform in China depends on the incentives of local governments, large numbers of which seek to promote economic gain and remove sources of economic inefficiency.

I also note that privatization in China has only taken its first — though gigantic — step; it has a long way to go. Privatization of small SOEs is not yet finished. After privatization, many problems remain. For example, the state still holds some (although often not controlling) shares; and there are many restrictions on share transfers. There also remains a question whether privatization will encompass the largest SOEs, mostly under the jurisdiction of the central government. It is possible that the central government will eventually privatize some of the largest SOEs since it also faces the same financial imperatives as local governments.

In this paper, I also characterize the evolution of China's financial system. Financial reform dallied behind reforms along other major fronts from early on. Sustained reform and development of the financial system requires more time and finesse. The PBC's competency in discharging its fiduciary responsibilities is a prerequisite. It alone is insufficient for regulating and coordinating financial flows toward desired objectives. A characteristic of a mature and functional financial system is the prompt and predictable responsiveness by the market to indirect coordinating mechanisms and control instruments. Among the essential ingredients for achieving that stage of development are: reconstructing the central bank system; strengthening the role

of PBC in implementing monetary policies; recapitalizing state-owned commercial banks for previously policy-directed bad loans that may no longer be recovered; increasing competition; strengthening bank supervision and prudential regulation; interest rate liberalization; developing comprehensive financial markets and financial instruments and improving the financial order.

In China's current stage of systemic transformation, fiscal measures are yielding more immediate and direct results than monetary policy. However, rapid economic growth and the rising importance of the market in China suggest that indirect control and coordination through a well-developed financial system will yield more efficient and refined results more predictably and swiftly than fiscal policies. Sustained growth depends heavily on the success of reforms in the financial system. China may easily adopt and adapt the expertise and technology that exist in the U.S. and other foreign financial systems. The transfer of experience and knowledge from abroad can help accelerate reform in China's financial markets.

This study also suggests that the state enterprise reform and financial liberalization are critical to the economic development in China. If the necessary reforms of the financial sector and state enterprises are effectively carried out, inevitably this will lead to a significantly slower rate of growth for a period of time. However, these reforms will provide the basis for a period of sustained growth in the long run.

APPENDIX
GLOSSARY OF ABBREVIATIONS

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ABC	Agricultural Bank of China
BIS	Bank for International Settlements
BOC	Bank of China
CCB	China Construction Bank
CHIC	China International Trust and Investment Corporations
FIEs	Foreign Invested Enterprises
ICBC	Industrial and Commercial Bank of China
IMF	International Monetary Fund
IOEs	Individually-Owned Enterprises
NBFIs	Non-banking financial institutions
PBC	People's Bank of China
PIEs	Private and Individual Enterprises
RCCs	Rural Credit Cooperatives
SCBs	State Commercial Banks
SOEs	State-Owned Enterprises
TICs	Trust and Investment Corporations
TVEs	Township and Village Enterprises
UCCs	Urban Credit Cooperatives

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